

The regulation of funded pensions: a conceptual framework for comparative analysis

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Staatliche Regulierung der privaten
und betrieblichen Alterssicherung



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The Regulation of Funded Pensions
A Conceptual Framework for Comparative Analysis

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Abstract: Some social policy analysts argue that the shift from PAYG towards more capital funding in pension policy in many European countries does not necessarily imply neo-liberal privatisation, but will probably lead towards a genuine social-liberal third way, i.e. **socially** regulated **welfare** markets' reconciling the tension between individual liberty and social solidarity. However, the scientific rationale of the term welfare market is uncertain because it was not exactly specified how this reconciliation should precisely be possible and what are the theoretical motivations and distinctive institutional features of **welfare** markets compared to unfettered markets and welfare states. While for paradigmatic critics of the shift towards capital funding this term must appear as a euphemistic oxymoron, neo-liberalism dismisses social regulation of pension markets as futile or even harmful. Refuting both objections and filling the theoretical gap, this article establishes a rationale for the term **welfare** market by showing why and how funded pension provision can be **socially** regulated, i.e. in a manner which takes concerns about social justice seriously while preserving basic market features. Finally, it is exemplarily examined whether funded pension regulation in European countries is actually heading towards welfare markets.

1. Welfare Markets – The Future Direction of Pension Policy?

Since the 1990s, PAYG pension systems in European countries have been under increasing political pressure. Regarding (projected) increases in PAYG contribution rates as economically unsustainable, many governments have enforced considerable cutbacks to PAYG benefits. Thus, citizens will increasingly have to rely on financial markets for securing status maintenance after retirement. What does this development mean for the future direction of pension policy?

While some social scientists speak of neo-liberal 'privatization', i.e. the 'surrender of public responsibility' for citizens' welfare (Gilbert, 2002), others have objected that the term 'privatization' does not adequately capture the ongoing pension policy change (Nullmeier, 2001: 646; Leisering 2006). Instead, they expect public institutions and market mechanisms to become increasingly intertwined: future pension policy will neither equal the establishment of unfettered markets as advocated by neo-liberalism nor the preservation of the provider welfare state of the social-democratic 20th century, but the emergence of public regulatory frameworks shaping markets in due consideration of social criteria. Legitimacy pressures concerning economic security in old age are supposed to prevent governments from

instituting unfettered markets. Less state via shrinking PAYG replacement rates is expected to be balanced by more state via **social** regulation of funded pensions. This is said to result in a new third way of pension policy, i.e. so-called **welfare** markets reconciling the tension between individual responsibility and social solidarity. Thus, social-liberal hybridisation instead of neo-liberal privatisation appears to be the more adequate analytical term.

However, the rationale of the term welfare market can be queried. On the one hand, neo-liberalism alleges that competitive markets represent the most efficient institution already producing maximum welfare for all participants (Berthold and Thode, 1998: 334). Hence, **social** regulations appear futile or even harmful. On the other hand, for paradigmatic critics of the shift from PAYG to funded pensions, the notion that pension markets can be regulated in accordance with principles of social justice seems to be a squaring of the circle from the outset. They predict that the shift towards more capital funding leads us back to the 'nineteenth century' (Schmähl, 2006) with its high extent of old-age poverty. Thus, the term welfare market appears to be a euphemistic oxymoron.

Therefore, it is problematic that the meaning of the term **welfare** market has only been broadly conceptualized as (socially regulated) markets pertaining to services the provision of which was formerly organized according to welfare state principles (Nullmeier, 2001; Taylor-Gooby, 1999). No attempt was made to thoroughly substantiate and clearly specify the theoretical rationales of the term welfare market and to describe its distinctive institutional features by which empirical analysis could distinguish them exactly from free markets and welfare states. But this is indispensable for empirically testing the hypothesis that European pension systems are being transformed into welfare markets.

Analysing the current scientific literature regarding funded pension regulation, a distinctive social-liberal ideal-type to be called welfare market can indeed be derived from this literature and distinguished from two other ideal-types of providing funded pensions, namely unfettered funded pension markets and funded pension welfare states. The concept of welfare markets is neither futile nor does it represent a euphemistic oxymoron. Firstly, it is doubtful that unfettered pension markets are efficient let alone equitable welfare producers. Expanding on Taylor-Gooby's (1999) critique, my analysis shows that many consumers in unfettered markets do not behave like rational actors. Therefore, they are subject to 'market manipulation' (Hanson and Kysar, 1999a + b; Bar-Gill, 2004). Secondly, a regulatory framework can be established that takes deviations from rational behaviour and concerns about distributive justice into account, thereby trying to encourage trust in markets (Taylor-Gooby, 1999: 111). This regulatory framework can be implemented without abandoning basic

market features (autonomy, choice, competition), thereby giving rise to socially regulated markets.

To substantiate my claims, I construct three different ideal-types of regulating funded pension provision which I dub Neoliberal Voluntarism, Social Liberalism, and Social-Democratic Collectivism. Chapter 2 describes their different general normative stances towards regulation. Chapter 3 identifies five regulatory challenges impacting the adequacy, equity and efficiency of funded pension provision, to which the ideal-types prefer different institutional responses in accordance with their respective core values and convictions. The purpose of the ideal-typology is to serve as a theoretical tool to comparatively and empirically assess the ideological nature of future regulatory policies, i.e. to determine to what extent funded pension schemes resemble neo-liberal unfettered markets, social-liberal welfare markets or social-democratic welfare states, whether the degree of collective responsibility for status maintenance in old-age is rather low, intermediate or high, and to what extent national regulatory policies diverge/converge. Chapter 4 shortly exemplifies the application of the ideal-typology to funded pension schemes in three European countries.

2. Three Ideal-Types of Regulating Funded Pension Provision

Max Weber, founder of the scientific concept of ideal-types, explains their scientific construction and function as follows:

An ideal type is formed by the one-sided accentuation of one or more points of view and by the synthesis of a great many diffuse, discrete, more or less present and occasionally absent concrete individual phenomena, which are arranged according to those one-sidedly emphasized viewpoints into a unified analytical construct. In its conceptual purity, this mental construct cannot be found empirically anywhere in reality. It is a utopia. Historical research faces the task of determining in each individual case, the extent to which this ideal-construct approximates or diverges from reality. (Weber, 1949: 90)

Based on Kohl's (2000: 116 ff.) recourse to Weber's conception of ideal-types for social policy analysis, I define an ideal-type of funded pension regulation as a theoretical construct representing a specific pattern of regulation, i.e. an internally consistent, normatively monistic

configuration of regulatory institutions based on a few core values and ideological convictions. Ideal-types must be distinguished from national systems, which often more or less mix regulatory measures reflecting different norms. An ideal-typology functions as a coordinate system (ibidem: 119) which enables empirical research to determine which national system is closer to which ideal-type and to analyse whether reforms of regulatory policies indicate a reinforced hegemony of an ideal-type (and its underlying ideology) or represent a shift towards another ideal-type.

Sorting out the various recommendations, concepts and norms contained in the theoretical literature concerning funded pension regulation, three ideal-types can be constructed. They correspond to three different general understandings of social justice described by Kersting (2000: 46 ff.).

Firstly, the ideal-type **Neoliberal Voluntarism** - corresponding to an **unfettered market** - follows the concept of **structural** egalitarianism, the egalitarian aims of which are directed at a basic legal framework ensuring **equality of formal rights** to individual freedom, but which is not concerned about unequal actual capabilities of different individuals to successfully use their freedom.

Secondly, the ideal-type **Social Liberalism** - corresponding to a **welfare market** - follows the concept of resource egalitarianism, the egalitarian aims of which are directed at the **equality of actual basic personal and situational preconditions of action** of different individuals, so that all citizens have sufficient resources and capabilities to take advantage of their freedom. However, divergences in the outcomes of actions are tolerated, because equalizing these would require overly paternalistic interventions in individual autonomy.

Thirdly, the ideal-type **Social-Democratic Collectivism** - corresponding to a **welfare state** - follows the concept of **welfare** egalitarianism, the egalitarian aims of which are directed at increasing the **equality of individual welfare outcomes**.

2.1. Neoliberal Voluntarism

Neoliberal Voluntarism is a **market fostering** gestalt of funded pension regulation derived from neo-liberalism. The normative funded-pension-model recommended by Littlewood (1998) comes close to this ideal-type. Its core values are liberty and individual responsibility. Human beings are regarded as rational, self-interested actors. Competitive markets are supposed to produce maximum welfare for all participants. The task of the state is just to ensure 1) provider competition, 2) security of private property rights, 3) a reliable legal

framework and 4) that citizens receive financial education and information about providers, products etc. Instead of adapting markets to individuals and their possible weaknesses, individuals should be made fit for vibrant financial markets by endowing them with financial savvy. The relation of the regulatory system to the individual can thus be termed **releasing**, reflecting the libertarian conviction that individuals should be freed from state paternalism and learn to help themselves.

Thus, Neoliberal Voluntarism endorses an unfettered market for funded pensions.

2.2. Social Liberalism

Social Liberalism is a **market shaping** gestalt of funded pension regulation derived from 'Libertarian Paternalism' (Sunstein and Thaler, 2003) and its application to funded pension regulation (Cronqvist, 2003; Gallery and Gallery, 2005; Iwry, 2005; James, 2005; Mitchell and Utkus, 2003). It rejects coercive state paternalism, but accepts a responsibility of the state to enable citizens to live a self-determined life by offering them a financially supportive and easily manageable institutional framework for retirement saving. Core values are real, not only formal autonomy and self-determination. Social Liberalism strives to balance social solidarity and individual responsibility/liberty by creating openings for individual choice while retaining a non-paternalistic state responsibility for the well-being of citizens (Leisering, 2006).

As Social Liberalism regards human beings as boundedly rational actors, its general conviction is that unfettered markets with complex products like pensions are prone to fail. Empirical research shows that many people have overconfident delusions about their competence to choose appropriate financial products and often make unwise decisions as they are misled by systematic cognitive biases, which are hardly remediable by financial education (Erturk et al., 2005; Mitchell and Utkus, 2003). However, instead of abolishing individual choice, Social Liberalism prefers the state to put suggestive, beneficial institutional frames and monetary incentives in place steering (not: forcing) people in welfare-promoting directions (Sunstein and Thaler, 2003). The relationship of the regulatory system towards the individual can thus be termed **enabling**. Freedom of personal choice is retained because it provides procedural utility by increasing the sense of personal control which correlates with increased life satisfaction (Iyengar et al. 2003, 2). Active, self-responsible management of own assets (instead of passively receiving state entitlements the value of which is subject to the vicissitudes of politics) is said to be empirically related to long-term health, individual

well-being, marital stability, higher educational attainment - even when controlling for intermediate variables like income and education (CSSS, 2001: 28 f.).

Thus, Social Liberalism endorses a welfare market for funded pensions - market mechanisms are basically preserved, but the market is socially shaped.

2.3. Social-Democratic Collectivism

Social-Democratic Collectivism is a **market neutralizing** gestalt of funded pension regulation, derived from traditional social-democratic universal welfare philosophy (Rothstein 1998). Its core values are solidarity and security. The starting point of this ideal-type is that most people are risk-averse. They put a high value on the predictability and security of (expected) living conditions (Meyer, 2005: 130). Moreover, they are not merely self-interested, but also driven by a sense of justice. People oppose markets when they think that participants do not receive the outcomes that they deserve according to principles of distributive fairness (Walster et al., 1978).

The normative funded pension model of Modigliani and Muralidhar (2004) comes close to this ideal-type, because it stresses the importance of intergenerational solidarity and puts a high value on the security and distributive fairness of funded pension provision. Detrimental financial market effects, particularly the 'welfare costs of defined contribution schemes' (ibidem: 71), should be prevented. As its central aim is to offset the volatility and insecurity of financial markets, the relationship of this regulatory system towards the individual can be termed **ensuring**. To achieve this security, individual choice is sacrificed.

Thus, Social-Democratic Collectivism endorses a welfare state for funded pensions.

3. Five Institutional Challenges of Regulating Funded Pension Schemes

Following Leisering (2006), funded pension regulation is defined here as comprising all legal, organizational and financial means by which collective actors (state or social partner organisations) can respond to (anticipated) failure of financial markets. Five¹ potential market failures jeopardizing the security, efficiency and equity of funded pension provision - and

¹ Further market failures - price discrimination against females (because of their higher average longevity), longevity risk (meaning retirees' myopic preference for lump sums instead of annuities) (Munnell and Sunden, 2004: 143), the problem of adverse selection in annuity markets, and inflation risk - cannot be treated here because of spatial limits.

thereby status maintenance in old-age - can be identified: myopia, volatility risk, choice risk, high charges, and insufficient saving resources.

The institutional response to each of these potential failures preferred by the ideal-types differs by the degree of collective versus individual responsibility for the handling of these challenges and hence by the extent of social policy, because Girvetz (1968, 512) conceptualized social policy as **societal, i.e. collective** responsibility for citizens' wellbeing. Neoliberal Voluntarism assigns responsibility first and foremost to individuals. Social Liberalism favours the sharing of responsibility between individual citizens and public authorities. Social-Democratic Collectivism prefers responsibility to be taken over by collective actors (public authorities or social partners).

3.1. Myopia

Myopia refers to the possible human tendency to undervalue future needs in old age compared to current desires. Should the state enforce saving in funded schemes for **status maintenance**?

Neoliberal Voluntarism endorses voluntary opt-in schemes, because individuals are regarded as rational, farsighted actors (Homburg, 1997: 65; von Weizsäcker, 2003: 30f.). Mandatory contributions to funded pension schemes are rejected because people perceive them as a tax (Börsch-Supan, 2004), creating labour disincentives and promoting the black market. Governments should only provide individuals with correct information about declining PAYG pensions (ibidem).

Social Liberalism, on the contrary, points out that the empirical evidence for myopia is well established (Munnell and Sundén, 2004) and that it cannot be remedied by education (Mitchell and Utkus, 2003). Especially individuals with low social status are prone to short-sightedness regarding retirement planning (Munnell and Sundén, 2004: 58). But even many middle-class people ignore the effect of compound interest and begin to save too late, necessitating considerably higher contribution rates to achieve status maintenance than under a prudent approach (Davis, 2004: 20).

However, because of its respect for individual autonomy (citizens may have good reasons for temporarily interrupting retirement saving) and to prevent encouraging illicit work, Social Liberalism abstains from mandating saving and resorts to automatic enrolment: all adult persons are automatically enrolled in funded pension plans, but are allowed to opt out. Strikingly, participation rates jumped from about 40% to about 85% as some occupational

pension plans in the US switched from voluntary opt-in to automatic enrolment with opting-out possibility (Mitchell and Utkus, 2003: 5). This shows that - contrary to the rational actor model - many people do not possess well-defined savings preferences but are inert and heavily influenced by institutional frames. Via automatic enrolment, Social Liberalism tries to strengthen and equalize the different individual mental preconditions of retirement saving, i.e. differing personal capabilities regarding self-control and long-term planning.

Social-Democratic Collectivism advocates mandating retirement saving as voluntary approaches do not reach full participation. Only compulsory saving guarantees that every pensioner is reasonably protected against his/her myopic young self, which is easily tempted by over-consumption because of status competition in unequal capitalist societies. Moreover, only mandatory participation effectively prevents annuity market failure because of adverse selection (Davis, 2004: 18, 28).

3.2. Volatility Risk

Volatility Risk refers to the fact that financial market developments are quite volatile, not only in the short-term, but even over retirement saving periods of up to 40 years. The corollary is that members of different birth cohorts **even with equal contribution sums and identical investment strategies** accumulate quite different retirement capital sums just because of historically different market developments. Moreover, different cohorts are confronted with different rates for converting accumulated savings in annuities because their amount depends on the different interest rates prevailing at retirement. This results in considerably different benefit levels for different cohorts (Burtless, 2000). Alier and Vittas (2001) found that the replacement rate for the luckiest cohort is three to four times higher than the replacement rate for the unluckiest cohort (max-min-ratio). Consequently, the contribution rate necessary to achieve a certain pension level is difficult to specify ex ante, and expectable benefit levels are quite unsure.

Nevertheless, Neoliberal Voluntarism endorses Defined Contribution (DC) plans. Contrary to empirical evidence (Burtless, 2000), some authors allege that financial market volatility only causes short-term fluctuations and is allegedly 'irrelevant' (Börsch-Supan, 2000) for long-term investments like pensions. Others argue that private insurance markets will automatically

provide reliable benefit guarantees if people request these (Hellwig in an interview with Heusinger and Ramspeck, 2005).

Contrary to this, Social Liberalism recognizes volatility risk. As employees are commonly poorly informed about this risk and take no precautions (Mitchell and Utkus, 2003: 18), savers should be automatically enrolled in 'life-cycle-funds' (Munnell and Sunden, 2004: 175). These funds aim to protect people against unexpected asset downturns before retirement by shifting the equity-bond-mix of the investment portfolio automatically gradually towards less volatile bonds with increasing customer age. Citizens can opt out of these funds but then must explicitly state that they are aware of volatility risk. The goal is to strengthen and equalize unequally distributed individual preconditions of action, namely different individual cognitive capabilities to consciously consider and handle volatility risk.

Social-Democratic Collectivism perceives the huge and arbitrary cohort inequalities produced by the financial market 'lottery' as unfair and 'repellent' (Modigliani and Muralidhar, 2004: 58 f.). The insecurity inherent in DC systems is regarded as being contrary to peoples' preference for secure benefit levels (Van Rooij et al., 2004). As even life-cycle-funds can reduce the Max-Min-Ratio merely to 2,7:1 (Alier and Vittas, 2001: 407), Social-Democratic Collectivism endorses intergenerational risk-sharing within funded Defined Benefit (DB) schemes.

Modigliani and Muralidhar (2004) have developed a sophisticated funded DB model based on the assumption that individuals are the least capable unit to bear volatility risk and that the latter are more easily borne if fairly distributed across cohorts. Their model operates with a guaranteed rate of return (ibidem: 38) equalling the rate of return on assets expected in the very long term and, concomitantly, a guaranteed income replacement rate. Individuals pay mandatory contributions to a single public investment fund which pools volatility risk across cohorts. Crucial for the functioning of this system are proper and transparent rules concerning the long-term-balance of its assets (value of total investments) and its liabilities (pension rights acquired). If the actual rate of return on assets is lower / higher than the long-term-expected, guaranteed rate of return, assets are lower / higher than liabilities, and the plan will display a deficit / surplus. However, contrary to pure DC systems, short-to-mid-term deviations from the expected long-term trend are tolerated without changing contribution rates or benefit levels by allowing temporary deficits / surpluses. Only if there are persistent deviations from the expected long-term trend, meaning that assets are constantly below / beyond a certain percentage of liabilities, contribution rates should be adjusted (risen / lowered).

This balancing is called intergenerational risk sharing: if asset prices fall unexpectedly low, not only the few cohorts retiring at that time have to bear the whole burden as in a DC system. Instead, either formerly established surpluses are used for compensation or all active cohorts share the risk with the retiring cohorts by an increase in contributions (if the plan's deficit is too high). Already retired cohorts can also be required to share the risk by partially reducing indexation of annuities in the case of unexpected massive long-term downturns. This would be an application of the Musgrave-Rule favoured by social-democratic welfare theory (Myles, 2002) to a funded pension system: financial market risks are shared equally between all living cohorts, so that the net income relation between the working and the retired generation remains stable.

Such a funded DB system is said to be both more efficient and fair:

The intergenerational pooling of risks provides benefits for all cohorts. [...] The solidarity between cohorts in such a scheme generates a substantial risk reduction in relation to individual saving. (Dutch Scientific Council for Government Policy, 2000: 45 ff.; see also Modigliani and Muralidhar 2004, 201)

...in a DC plan the time horizon is the life of one individual, whereas in DB plans the time [i.e. investment, T.H.] horizon is much larger. For these reasons, DB plans on average can take on more risk and generate higher returns. (Modigliani and Muralidhar, 2004: 6)

3.3. Choice Risk

Choice Risk means that individuals may choose providers or investment products that are not appropriate.

From the perspective of Neoliberal Voluntarism, competitive markets are the ultimate 'discovery device' (von Hayek) providing sophisticated customers with a wide variety of products perfectly suited to highly individualized preferences. Rational individuals will choose what is best for them. Sufficient prevalence of consumer sovereignty is not empirically examined, but is theoretically determined as given: 'The assertion that employees are unable to obtain the knowledge to make a rational choice violates the presumption of consumer sovereignty.' (Drew and Stanford, 2003: 105)

In contrast, Social Liberalism doubts the alleged merits of unfettered competition and choice in a market for complex products like pensions: ‘The lesson is that unfettered choice is a mistake in mandatory old age security systems because many workers are inexperienced in assessing financial alternatives. Structured choice is needed to prevent big mistakes and high fees’ (James, 2005: 9). Firstly, retirement plans offering too many investment options discourage participation by producing ‘choice overload’, i.e. by overwhelming many peoples’ cognitive processing capabilities (Iyengar et al., 2003). Secondly, pointing out to widespread mis-selling of endowment mortgages and personal pensions in the UK (Erturk et al., 2005) and to empirical research showing that ordinary citizens are far from being rational investors (Mitchell and Utkus, 2003), it is argued that peoples’ choices are often subject to non-rational cognitive biases. These are intensified and exploited by advertising (Kahneman et al., 2005). Hence, pension markets confirm the general thesis of ‘market manipulation’ (Hanson and Kysar 1999a + b; Bar-Gill 2004), according to which competitive pressures drive profit-seeking providers to exploit consumers’ non-rational cognitive biases by distorting their preferences and perceptions unless regulation prevents it.

Cronqvist (2003) provides a thorough empirical analysis of customers’ non-rational biases and their interaction with advertising in the Swedish Premium Pension market launched in 2000. Although the government undertook intense efforts to secure that citizens are well informed, Cronqvist came to three central conclusions:

Firstly, many people were subject to the familiarity bias: they preferred to choose funds with which they are more familiar irrespective of their adequacy. Providers in Sweden played on this cognitive bias by advertisements associating the pension fund with famous persons familiar to citizens like film-stars or by constantly spreading their brand name. They used these non-informative advertisements to avoid profit-reducing fee competition. Funds using non-informative advertisements indeed attracted most customers, although they charged higher fees, thereby considerably lowering account balances. Another form of familiarity bias is the preference of investing in home-country-specific funds. This exposes people to the highly problematic risk of undiversified portfolios. Some pension funds intensively played on such biases through advertisements by boasting that they invest exclusively in Sweden. As a result, active choosers put on average 48% of their contributions into Swedish assets.

Secondly, many people were subject to the extrapolation bias. Swedes allocated more money to funds that stressed performance-advertising (i.e. displaying high returns in the recent past) because citizens regarded a fund’s past return as a reliable indication for its performance and extrapolated them into the future. But many studies (cited in Cronqvist, 2003) show that

reliance on past performance is an inappropriate investment strategy due to low long-term persistence of the returns of a fund. Good short- and mid-term performance of a fund is often simply the result of market luck. Pension funds in Sweden successfully played on this cognitive bias as performance in the recent past has been a common cue in advertising and attracted many Swedish customers. For example, the most popular fund displayed a terrific market performance of +534% in the years before the start of the Premium Pension Market, but exhibited a below-average market performance of -69,5% during the three years afterwards (Cronqvist and Thaler, 2004: 427).

Thirdly, many people are inert because they are subject to the status quo bias (see also Van Rooij et al., 2004: 5). Although their initial choices were often inadequate, over 90% of Swedish contributors did not re-allocate their portfolios between 2001 and 2003 (Cronqvist and Thaler, 2004). Thus, funds with inadequate investment strategies were not punished to the extent necessary for competition to function appropriately.

To summarize:

The Swedish experience shows that many individual investors (indeed, many more than expected) paid attention to non-informative fund advertising, made an active choice, and chose portfolios with the opposite characteristics of those most economists would find attractive. (Cronqvist, 2003: 31)

The combination of investor insensitivity to fees, responsiveness to marketing and eagerness to chase trends encourages mutual fund companies to charge high fees, to spend heavily on marketing and to launch specialized, poorly diversified funds. Thus investors get lower average net returns and greater potential variation in retirement wealth. (Kahneman et al., 2005)

However, since Social Liberalism is committed to the idea of individual self-determination, personal investment choice should not be completely eliminated. Rather, appropriate choices should be promoted by automatically enrolling citizens in an institutional framework with adequately restricted choice (Cronqvist, 2003). The public regulator should construct a pension scheme with a few well-diversified index-funds with clearly distinguishable risk-potentials managed by a few investment companies chosen in periodic competitive bidding (James, 2005). Index-funds are passively managed, i.e. they imitate the whole capital market by replicating the asset compilation of a market index (e.g. the S&P 500), instead of money

managers actively picking particular asset-mixes. Index funds significantly outperform net returns of average actively managed funds (James, 2005: 16; Vidler, 2003: 31) because they save on money manager staff without incurring lower investment returns. The motive behind such an 'institutional market' (James, 2005) is to enable individuals to take care of themselves by simplifying the situational preconditions of individual action, thereby strengthening and equalizing individual investment decision capabilities. An often mentioned example is the pension scheme for federal state employees in the US, the 'Federal Thrift Savings Plan'.

Social-Democratic Collectivism abandons individual choice and advocates monopolistic public or corporatist funds managed by independent boards chosen by the state/the social partners. Most people are regarded as uninterested in choice as nowadays passive behaviour in the Swedish Premium Pension and Australian Superannuation Scheme shows (Modigliani and Muralidhar, 2004: 222). Moreover, individual choice increases inequality. Research in the US shows that rich individuals have more investment experience and access to better advice than poorer people (ibidem: 59). The conclusion drawn from these observations is that...

'...there is no reason to establish a set of pension companies who compete with one another to 'beat the market'. By definition, not everyone can beat the average. So placing workers in pension funds that hold different assets is a prescription for increasing the inequality in their accumulated pension wealth. The simple way around this problem is to require that all workers' pension be invested in the same portfolio. In this case, one doesn't need a pension industry to invest pensions or to pay high fees collected by top money managers.' (Kotlikoff, 1999: 20 f.)

According to Modigliani and Muralidhar (2004: 60 f.), the objection that the monopolistic public funds recommended by them are prone to mismanagement represents a neo-liberal myth propagated by the World Bank with the help of biased data samples. Insulation of the investment strategies of public funds against political meddling should be ensured by appropriate governance structures, especially the constitutional independence of the board and an indexed investment style (Modigliani and Muralidhar, 2004: 37). To prevent abuse of power in these monopolies, contributors can be given voice by electing member councils equipped with significant legal rights as in Dutch occupational schemes (Bieber and Schmitt, 2004).

3.4. High Charges

Whereas administrative costs in PAYG schemes are usually low, charge levels represent a hot topic regarding funded pension systems (Furman, 2005). Here, assets have to be managed, a variety of products developed and marketed, switches of customers between companies dealt with and profit expectations realised. Administrative costs are very important for the affordability of funded pensions because a yearly deduction of 1% of assets results in a 22%-reduction of the capital accumulated after 40 years (Vidler, 2003: 29). Moreover, flat rate charges independent of account balances are particularly burdensome for low earners with small savings.

From the perspective of Neoliberal Voluntarism, unfettered competition between private pension providers will automatically result in affordable fees (Gerber, 2003).

Market competition ensures that profit aspirations steer companies' efforts in a direction which creates the highest welfare for all. This is the reason for the superiority of the market economy over all other institutional options. The task of the state consists in ensuring competition. (Vanberg and Goldschmidt, 2005; my translation)

Social Liberalism does not share this unconditional faith in competitive markets but emphasizes that it is the structure of the market (its degree of centralization) that matters. In decentralized retail markets, average annual charges are huge, reaching 1,5% of assets in the US and 2% in Australia (James, 2005: 12). Likewise, it was found that administrative, switching and annuitization costs reduced accumulated retirement capital sums in the UK retail market by roughly 40% (Murthi et al. 2001).

Besides diseconomies of scale and high marketing costs, this results from lower bargaining power of single consumers compared to that of collective (state/corporatist) actors bargaining on behalf of groups (citizens/employees). Moreover, consumers are inert, reacting only sluggishly to price differences in pension markets (Binswanger, 2005: 105). For instance, in Australia, 52% of all accounts are (mostly voluntarily) held with expensive, underperforming funds (Vidler, 2003: 34). Furthermore, expensive funds represent themselves successfully as low cost funds through advertisement (ibidem: 37) because it is very difficult for customers to infer actual cost levels from deliberately complicated charge structures (Erturk et al., 2005). 'The upshot is that most laymen will hardly be able to perform such cost comparisons.'

(Binswanger, 2005: 107 f., my translation). Again, this confirms the 'market manipulation' thesis (Hanson and Kysar 1999a + b; Bar-Gill, 2004).

Therefore, Social Liberalism mandates that charges have to be levied as a percentage of personal assets equal for all accounts, so that individuals with large account balances indirectly subsidize individuals with low account balances (James, 2005). But most importantly, it advocates a centralized 'institutional market' like the 'Federal Thrift Savings Plan', where annual charges are kept down to a low level of 0,1% of assets (ibidem). Here, administration of payments and organization of individual accounts is centralized in one publicly administered complex (thereby exploiting economies of scale) and consumer choice is restricted (thereby lowering administration and switching costs) to six passively managed index-funds (thereby holding down asset management costs) administered by one investment company. The latter is periodically chosen by the public regulator through competitive bidding (thereby avoiding marketing costs), using its all-or-nothing bargaining power. The social-liberal motive behind such an institutional market is to enable citizens to take care of themselves by relieving them from needlessly high charges.

Social Democratic Collectivism strives to reduce costs by exploiting economies of scale through a single national pension fund (Modigliani and Muralidhar, 2004) or industry-wide occupational funds (Ebert, 2001). Here, administration costs are reduced by obviating marketing, abolishing individual investment choice and administrating pension plans on a corporatist non-profit basis. Administrative expenses are indeed considerably lower in centralized industry-wide sector funds than in decentralized individual account systems (Döring, 2002: 115).

3.5. Insufficient Saving Resources

Some citizens may not have the financial means to afford to save in funded pension schemes. Should the state subsidize their accounts?

From the perspective of Neoliberal Voluntarism, individuals themselves are responsible for their status maintenance. It suffices that the state provides a safety net against old-age poverty. **Direct** subsidies for saving in funded pension schemes are feared to put a strain on public finances and to create a culture of dependency, thereby undermining incentives to rely on individual efforts.

However, Neoliberal Voluntarism also advocates the taxation of funded pensions according to the deferred expenditure taxation principle (Whitehouse, 1999), the EET-model: contributions

are deducted from taxable income (E), investment gains are tax-exempt (E), and only pension benefits are taxed (T). Therefore, saving is heavily **indirectly** subsidized because investment gains are not taxed. Moreover, in a progressive tax system, tax rates applied to benefits in old age are usually lower than those during working life (as personal income in old age is normally lower). Neoliberal Voluntarism endorses the EET-model because taxation of capital yields is regarded as 'a disincentive to saving, because [then] consumption now is worth more than consumption in the future' (Whitehouse 1999, 7). Furthermore, people perceive up-front tax relief as more valuable (ibidem, 36). Participation in voluntary pension schemes void of the tax incentives resulting from the EET-model is likely to be low. This would probably create political pressures to maintain PAYG pensions beyond subsistence levels - something which neo-liberalism wants to avert.

The subsidization policy of Social Liberalism (Iwry 2005, 3 ff.) follows the EET-model, too. Discouraging saving by taxing contributions and investment yields is contrary to its intention to strengthen peoples' retirement planning willingness and savings resources. However, it critically recognizes that high income earners with high tax rates disproportionately benefit from the EET-model, whereas low income earners with zero or low tax rates do not or hardly benefit. This contradicts its goal to distribute preconditions of actions (here: financial resources for saving) more equally across different income strata. Therefore, Social Liberalism supplements the EET-model by direct state subsidies targeted at financially weaker people, gradually diminishing towards middle income levels (as in the German 'Riester-Rente' and the Australian 'Superannuation Co-Contribution').

However, as Social Liberalism repudiates a culture of welfare dependency, these targeted allowances and their amount are made conditional on the amount of peoples' own contributions (relative to their personal income) (Iwry 2005, 16). Activating financially disadvantaged people to help themselves by offering them conditional public assistance corresponds to the social-liberal doctrine of rights and responsibilities. Empirically, contribution matching indeed enhances participation rates (Munnell and Sunden, 2004: 58).

In contrast, Social-Democratic Collectivism is adamantly opposed to the regressive distributional effects of the EET-model (Hughes and Sinfield, 2004). For example, in the US (which operates an EET-system), two thirds of all tax exemptions granted go to the wealthiest 20% of all citizens, while only one eighth goes to the bottom 60% of the income distribution (ibidem: 181). Hence, the expenditure taxation principle is held to be irreconcilable with any principle of equity (Hughes and Sinfield, 2004: 183). Therefore, Social-Democratic Collectivism endorses the comprehensive income taxation principle, the TTE-model, meaning

that contributions cannot be deducted from taxable income (T), investment gains are taxed (T), and only pensions benefits are tax-exempt (E).

Instead of regressive tax exemptions, the Social-Democratic principle of universal solidarity commands that all citizens have a social right to a flat-rate cash allowance granted by the state. Financing this flat-rate subsidy out of progressive taxation, savings are redistributed from rich to poor citizens, corresponding to the Social-Democratic concern for reducing outcome inequality. These subsidies should not be targeted towards the poor, because targeted subsidies are feared to receive no political support from middle-class voters so that their real value will erode over time (due to insufficient indexation of these subsidies to inflation/wages). In contrast, universal social policies like universal subsidies for funded pensions receive middle-class support, so that political pressure will be high enough to maintain the value of these subsidies in the long-run (Korpi and Palme, 1998).

4. European Funded Pension Schemes on the Way to Welfare Markets?

Applying ideal-typologies to empirical cases does not mean assigning each national case to one ideal type but to 'determine which (plural) of these types are to be found within empirical cases, in roughly what proportions' (Crouch 2005, 26). This is done here with regard to funded pension schemes in the Netherlands, Sweden, and the UK to find out whether regulation in European countries exhibits a convergence towards social-liberal welfare markets. In 1990, each of these countries belonged to one of three very different groups of pension systems: Sweden was part of that country group (besides Austria, France, Germany, Italy) which ensured average earners' status maintenance via **mandatory public PAYG** pensions. The Netherlands belonged to that group of small countries (besides Finland, Iceland, Switzerland) which secured status maintenance via **(quasi-)mandatory, funded occupational** pensions. In the UK and Ireland, participation in **voluntary, funded private or occupational** pensions was indispensable for status maintenance. Hence, the three countries are well suited to get a preliminary indication whether there is convergence towards social-liberal welfare markets which erodes former institutional differences.

The regulation of Dutch quasi-mandatory occupational pensions, regulated by two main laws dating back as far as 1949 and 1954, and managed by the social partners is dominated by Social-Democratic Collectivism. Participation is quasi-mandatory via statutorily extended

corporatist agreements, volatility risk is offset by intergenerational risk-sharing, and employees have no investment choice in the monopolist pension funds of industry sectors and large companies. During the 1990s, part-time employees, workers of temporary employment agencies and workers with fixed-term jobs have been integrated into the scheme, so that participation increased to 94% of the workforce. However, the taxation method (EET) corresponds to Neoliberal Voluntarism. Moreover, a few Dutch companies have recently switched to defined contribution plans (Van Het Kaar, 2004) so that the spread of intergenerational solidarity is no longer universal. But up to now, the social-democratic nature of the Dutch scheme shows a high degree of path dependence. Welfare market elements are missing.

The regulation of the Swedish 'Premium Pension' scheme introduced in 2000 as a compensation for cutbacks in the PAYG scheme (ATP) mixes neo-liberal elements (defined contribution, unrestrained individual investment choice, EET taxation), social-democratic elements (mandatory participation, a guaranteed minimum interest rate of 2,7% for converting account balances in annuities, state contributions on behalf of unemployed and child caring people) and social-liberal elements. The latter consist in the fact that the administration of the pension market is carried out on a centralized basis by a public body, the Premium Pension authority (PPM), so that annual average charges are reduced to 0,7% of assets with further reductions to 0,25% expected in the future. Furthermore, those citizens who abstain from actively choosing a fund (meanwhile over 90% of new entrants) are automatically enrolled in a high-quality default fund (Cronqvist and Thaler 2004) managed by the PPM. The significance of this can be seen in comparison to the Australian Superannuation scheme where employers usually determine default funds which are of varying and often questionable quality (Gallery & Gallery 2005). While the Swedish Premium Pension scheme cannot be regarded as a welfare market, it contains some important elements of this ideal-type.

In the UK, the 'Stakeholder Pension' scheme was introduced in 1999 to offset the declining coverage of occupational pensions. It is dominated by neo-liberal elements: participation is voluntary, investment choice is unrestricted and taxation follows the EET-model. To be sure, maximum annual charges are limited to 1,5% for the first ten years of membership and 1% afterwards, but this is a quite high level and providers are allowed to levy further hidden charges. The reason for the high charges is that - contrary to the Swedish Premium Pension scheme - administration is not centralised. Since April 2005, the scheme contains a welfare market element as subscribers are automatically enrolled in life-cycle-funds. However, the current dominance of neo-liberal over social-liberal elements is likely to be reversed. The

British government has recently released a white paper (DWP 2006) suggesting the introduction of a National Pension Savings Scheme (NPSS). As proposed by the Pensions Commission (2005), this scheme would feature automatic enrolment and centralized administration by a public body similar to the Swedish PPM, meant to reduce annual charges to 0,3% of assets. Moreover, the government explicitly conceded (DWP 2006, 56) that many Britons suffer from cognitive choice and information overload when it comes to financial investments. Therefore, the social-liberal delivery model of the Pension Commission, which has advised to limit the number of investment choices in the scheme to 6-10 appropriate funds (Pension Commission 2005, 376), is assumed to be the most suitable (DWP 2006, 56). The closer the final legislation to the commission's proposal, the more the NPSS will resemble the social-liberal ideal-type of the welfare market.

5. Conclusion

Welfare markets for funded pensions aim to reconcile individual liberty/responsibility and social solidarity by defusing potential failures of unfettered markets via beneficial institutional frames and monetary incentives while broadly preserving basic market features (individual autonomy, choice, and competition) instead of abolishing these as traditional provider welfare states do.

While longstanding, satisfactorily operating social-democratic funded pension schemes like the Dutch one exhibit path-dependency, recent reform legislation and proposals in countries with ailing pension systems like the British and Swedish one have increasingly resorted to welfare market elements and social-liberal ideas. The report of the British Pensions Commission and its impact on the government's white paper represents the strongest indication up to date that the diffusion of neo-liberal pension policy is coming to an end and that future pension regulation will be increasingly infiltrated by social-liberal ideas.

It remains to be seen to what extent welfare markets will actually achieve their aims. Welfare markets may have weaknesses. For example, because of possibly increasingly volatile capital markets (Aglietta & Rebérioux 2005) and in the face of financial market downturns possibly lying ahead in the coming decades - ironically because of demographic ageing (Davis and Li, 2003) - intergenerational risk-sharing may be a more convincing response to volatility risk

than life-cycle-funds. However, intergenerational risk-sharing can be subject to regulatory failure as the myopic management of many Dutch occupational pension funds in the 1990s has shown (Grünell, 2002). Hence, the current shift from PAYG towards funding is no easy escape-route out of the problems posed by demographic ageing.

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